DESCRIPTION OF SELECTED FEDERAL TAX PROVISIONS THAT IMPACT LAND USE

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

On July 16, 1996

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on July 16, 1996, on issues relating to the impact of Federal tax law on land use. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes selected provisions of Federal income tax and estate and gift tax law that may have an effect on the way land is used.

[1] This document may be cited as follows: Joint Committee on Taxation, Description of Selected Federal Tax Provisions That Impact Land Use (JCX-37-96), July 11, 1996.

DESCRIPTION OF PRESENT-LAW TAX PROVISIONS

A. Cost Recovery for Land

In general

A taxpayer generally must capitalize the cost of property used in a trade or business. The capitalized cost of business property that is subject to exhaustion, wear, tear, or obsolescence may be recovered over time through allowances for depreciation (sec. 167). Depreciation allowances for tangible property placed in service after 1986 generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which provides that depreciation is computed by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property acquired after July 25, 1991, generally is amortized under section 197, which provides a 15-year recovery period and applies the straight-line method to the cost of applicable property.

Under MACRS, depreciable property is divided into nine classes (3-year property, 5-year property, 7-year property, 10-year property, 15-year property, 20-year property, 27.5-year residential rental property, 39-year nonresidential real property and 50-year railroad grading or tunnel bores). An asset generally is sorted into a property class based upon its class life. The 200-percent declining balance method of depreciation is used for 3-year, 5-year, 7-year, and 10-year property; the 150-percent declining balance method for 15-year and 20-year property and any property used in a farming business; and the straight-line method for other property, including most depreciable real property.

Treatment of land

The cost of land generally may not be depreciated,[2] even if the taxpayer's use of the land may result in its erosion or other type of wear or tear (e.g., in the case of certain farming practices).[3] In addition, any interest in land may not be amortized under section 197 (sec. 197(e)(2)). Thus, when a taxpayer acquires both land and other property in a single transaction (e.g. the purchase of an apartment building and the underlying land), the acquisition cost must be allocated between the nondepreciable and depreciable assets.

Some improvements to land (such as sidewalks, roads, landscaping, etc.) may be depreciated.[4] However, certain land improvements may be so "inextricably associated" with the land as to be nondepreciable. Examples of nondepreciable land improvements

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[2] Treas. reg. sec. 1.167(a)-2.

[3] Treas. reg. sec. 1.167(a)-6(b) and Duda & Sons, Inc., 560 F.2d 669 (5th Cir. 1977).

[4] Rev. Proc. 87-56, 1987-2 C.B. 674.

include certain clearing and grading costs associated with land[5] and golf course improvements.[6]

The cost of minerals and other natural resources imbedded in land are recoverable through depletion allowances (sec. 611).

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[5] Rev. Rul. 65-256, 1965-2 C.B. 52, and Rev. Rul. 68-193, 1968-1 C.B. 79.

[6] Rev. Rul. 55-290, 1955-1 C.B. 320.

B. Income Tax Treatment of Disposition of Land

Capital gains treatment

In general, gain or loss reflected in the value of an asset is recognized for income tax purposes at the time the taxpayer disposes of the property. On the sale or exchange of capital assets held more than one year, gain generally is taxed to an individual taxpayer at a maximum marginal rate of 28 percent. Losses from the sale or exchange of capital assets are deductible only the extent of the gains from the sale or exchange of such assets, plus, in the case of individuals, $3000.

Land is a capital asset unless held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or is used in the taxpayer's trade or business. In addition, if the gains from property, including land, used in a taxpayer's trade or business exceeds the losses from such property, the gains and losses are treated as capital gains.

Deferral of gain or loss

Several provisions allow a taxpayer to defer gain when property, including land, is disposed of. For example, if land held for investment or business use is exchanged for property of a like kind (generally defined to include other real estate) gain or loss is deferred (sec. 1031). Likewise if land is condemned and replaced with other property of a like kind, gain or loss is deferred (sec. 1033).

Principal residence

If a principal residence, including the land on which it is located, is sold and replaced with another principal residence within two years, gain is deferred (sec. 1034). If a taxpayer age 55 or over sells property used as a principal residence for three of the prior five years, up to $125,000 of the gain may be exempt from tax (sec. 121).

C. Tax Credit for Rehabilitation Expenditures

In general

An income tax credit is provided for a portion of certain expenditures incurred in the rehabilitation of certified historic structures and certain other buildings first placed in service before 1936. The amount of the credit is 20 percent of the qualified rehabilitation expenditures for a certified historic structure and 10 percent of the qualified rehabilitation expenditures for a qualified rehabilitated building other than a certified historic structure.

In order for a rehabilitation to qualify for the credit applicable to certified historic structures, the rehabilitated building must be listed in the National Register of Historic Places, or be located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district. In addition, the Secretary of the Interior must certify that the rehabilitation is consistent with the historic character of the building or the historic district in which the building is located.

In the case of other rehabilitations, a building (or its structural components) is a qualified rehabilitated building if: (1) the building is substantially rehabilitated, (2) the building was placed in service before the beginning of the rehabilitation, (3) the rehabilitation meets a 75-percent retention test, (4) depreciation is allowable with respect to the building, and (5) the building was first placed in service before 1936.[7]

A building is substantially rehabilitated if the qualified rehabilitation expenditures incurred during the 24-month period selected by the taxpayer exceed the greater of: (1) the adjusted basis of the building (and its structural components) as of the beginning of the period (or as of the holding of the building, if later), or (2) $5,000.

Qualified rehabilitation expenditures generally include any amounts properly chargeable to capital account in connection with the rehabilitation of a building, but do not include the cost of: (1) acquiring the building or any interest in the building, (2) facilities related to a building (e.g., a parking lot), (3) enlarging an existing building, or (4) rehabilitations allocable to a portion of a building that is (or is reasonably expected to be) tax-exempt use property.

The 75-percent retention test requires the retention, in place, of: (1) at least 75 percent of the building's existing external walls (including at least 50 percent as external

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[7] The requirement that the building be placed in service before 1936 in order to be eligible for the credit was added by the Tax Reform Act of 1986 ("1986 Act"). Prior to the 1986 Act, the rehabilitation tax credit was a three-tier credit. The credit was 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures. The three-tier structure was added by the Economic Recovery Tax Act of 1981.

walls) and (2) at least 75 percent of the building's internal structural framework. In general, a building's internal structural framework includes all load-bearing internal walls and any other structural supports, including the columns, girders, beams, trusses, spandrels, and all other items that are essential to the stability of the building.

Other rules

The rehabilitation credit is part of the investment credit which, in turn, is part of the general business credit. The general business credit may offset the first $25,000 of a taxpayer's regular tax liability, plus 75 percent of the taxpayer's regular tax liability in excess of $25,000. The general business credit is not allowed to offset a taxpayer's minimum tax liability.

Taxpayers claiming the credit must reduce their adjusted basis in the building by the amount of the credit. Capitalized rehabilitation expenditures must be depreciated using a straight-line method.

The credit is subject to recapture if the rehabilitated building is disposed of or otherwise ceases to be a qualified property within five years after the property is placed in service.

D. Environmental Remediation Expenditures

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. Woolrich Woolen Mills v. United States, 289 F.2d 444 (3d Cir. 1961) .

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the Plainfield Union valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the

equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94-38, 1994-1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the Plainfield Union valuation analysis.[8] However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

More recently, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination of the land. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In a TAM issued on January 17, 1996, the IRS revoked and superseded TAM 9541005. Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

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[8] Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

E. Empowerment Zone and Enterprise Community Tax Incentives

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[9] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The designated areas were selected from among over 500 areas nominated by State and local governments, which submitted proposed strategic plans to promote economic development in these areas.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) special tax-exempt financing for certain zone facilities (described in more detail below).

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

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[9] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (N.J.).

The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, Willacy counties, Texas).

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000 (whichever is greater).

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the use of the business property occurs within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[10] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

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[10] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B)(e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond unified State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State.

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above) the principal user of which is an "enterprise zone business" (also defined above[11]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community. These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all outstanding qualified enterprise zone bonds for each qualified enterprise zone business may not exceed $3 million per zone or community. In addition, total outstanding qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all zones and communities.

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[11] For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

F. Use of Tax-Exempt Bonds

In general

The Code exempts interest on certain debt obligations of States, territories, and possessions of the United States from the regular individual and corporate income taxes (sec. 103). Interest on debt of local governments generally receives identical treatment to that provided for States.[12] The State and local government bond interest exemption applies to two principal types of bonds. First, interest is tax-exempt on bonds issued to finance public activities conducted and paid for by States and local governments themselves ("governmental bonds"). Examples of activities financed with governmental bonds are schools, courthouses, roads, public mass transit systems, and governmentally owned and operated water, sewer, and electric facilities.

The second major category of State and local government bonds on which interest is tax-exempt consists of bonds issued by these governmental units acting as a conduit to provide financing for private persons ("private activity bonds"). Unlike governmental bonds, tax-exempt private activity bonds generally may only be issued for purposes specified in the Code. The specified purposes include several activities related to private land use and real estate development.

Private activity bonds

Exempt-facility bonds

Exempt-facility bonds are private activity bonds issued to finance certain privately operated transportation facilities (airports, ports, mass commuting facilities, and high-speed intercity rail facilities); municipal service facilities (water, sewage, solid waste, local furnishing of electricity or gas, environmental enhancement of hydroelectric dams, and local district heating and cooling facilities); hazardous waste disposal facilities; and multifamily rental housing.

Bonds for each of these private activities are subject to extensive Federal targeting criteria. For example, developers of housing receiving tax-exempt financing must agree that either (1) 20 percent of the rental housing units will be occupied by tenants having incomes of 50 percent or less of the area median income where the project is located, or (2) 40 percent of the rental housing units will be occupied by tenants having incomes of 60 percent of less of the area median income where the project is located. This low-income tenant occupancy requirement must be continuously satisfied for a minimum period of 15

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[12] Interest on these "State and local government bonds" may, in certain cases, be includible in calculating the individual and corporate alternative minimum taxes. Additionally, State and local government bond interest is included in determining whether a portion of Social Security benefits is taxable under the regular individual income tax.

years after the State and local government bonds are issued. The Code includes extensive rules to ensure that developers comply with this requirement.

Qualified redevelopment bonds

Qualified redevelopment bonds are State and local government bonds issued for the redevelopment of private property in governmentally designated "blighted areas." In addition to any private revenues pledged to repayment of these bonds, the bonds must be backed by a pledge of governmental tax revenues. The term "blighted area" is defined as an area designated by a local government pursuant to a State statute as having excessive vacant or abandoned land and structures, substandard structures, or real property tax delinquencies. Designation of blighted areas is subject to limits on minimum size per area, and aggregate designations may not exceed areas comprising 20 percent of the assessed value of real property in the government's jurisdiction.

Qualified redevelopment bonds may be used for acquisition of property; clearing, rehabilitation, and redevelopment activities; and expenses of relocating area residents. This tax-exempt financing may not be used for new construction or enlargement of existing buildings. Facilities such as golf courses, suntan parlors, racetracks, casinos and other gambling facilities, and liquor stores may not be financed with loans financed with these bonds.

Empowerment zone and enterprise community business bonds

State and local government bonds may be issued to finance capital expenditures of certain businesses that are located in Federal empowerment zones and enterprise communities and that are eligible for other tax incentives provided to empowerment zone businesses. The following types of business are not eligible for this tax-exempt financing: golf courses, country clubs, massage parlors, hot tub facilities, suntan parlors, gambling facilities (including race tracks), and off-site alcoholic beverage stores.

The amount of these bonds is limited to $3 million per business in any one zone. Businesses receiving this tax-exempt financing further are subject to a $20 million aggregate limit on such bonds for property in all zones. Businesses receiving this tax-exempt financing must continuously qualify as a "zone business" throughout the term of the tax-exempt financing provided.

Qualified small-issue bonds

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for an single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the

same municipality or county. This $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the limit. Outstanding aggregate borrowing under this program is limited to $40 million per borrower (including related parties) regardless of where the property is located.

Mortgage revenue bonds

Present law authorizes issuance of two types of tax-exempt bonds for owner-occupied housing: qualified mortgage bonds and qualified veterans' mortgage bonds. Qualified mortgage bonds are bonds issued to provide below-market financing to first-time homebuyers having incomes below prescribed maximums and who purchase homes having purchase prices below prescribed maximums. Only principal residences may be financed with the proceeds of these bonds. If homebuyers sell the bond-financed homes within nine years after the loan is made, a portion of the subsidy provided by the tax-exempt interest rate is recaptured by the Federal Government. In addition to housing purchases, qualified mortgage bonds may be used to finance limited amounts of home improvement and rehabilitation loans.

Only five States are permitted to issue qualified veterans' mortgage bonds.[13] Unlike qualified mortgage bonds, qualified veterans' mortgage bond-financed loans are not restricted to first-time home buyers satisfying income criteria, there is no limit on purchase price of homes that are financed, and there is no recapture of the Federal tax subsidy if property is sold early. Since 1984, issuance of these bonds is being gradually phased out. The phase-out is accomplished by (1) limiting issuance to States that had issued the bonds before 1985, (2) limiting each State's annual issuance to an amount not exceeding its historical issuance of the bonds, and (3) limiting eligibility for bond-financed loans to veterans who served on active duty before 1977 and who apply for a loan within 30 years after leaving active military service (January 31, 1985, if later).

General restrictions on State and local government bond financing for private activities

Like many Federal direct spending programs, issuance of State and local government private activity bonds is subject to general restrictions on amount and use. The following discussion illustrates some of the major restrictions.

State volume limitations.--Issuance of most tax-exempt private activity bonds is subject to annual per-State volume limitations. Each State (including local governments within the State) is allowed to issue an annual amount of these bonds not exceeding the

[13] The States are Alaska, California, Oregon, Texas, and Wisconsin.

greater of $50 per resident of the State or $150 million.[14] States may elect to carryover their unused private activity bond volume authority for designated activities for a period of up to three years. Bond authority that is not used within the carryforward period lapses.

The State volume limits do not apply to State and local government bonds for section 501(c)(3) organizations, for airports and ports, for governmentally owned (but privately operated) solid waste disposal facilities, for environmental enhancements of hydro-electric generating facilities, for governmentally owned (but privately operated) high-speed intercity rail facilities,[15] and for qualified veterans' mortgage loans.[16]

Other restrictions on private activity bonds.--Among the other Federal restrictions applicable to private activity, but not to governmental, State and local government bonds are the following:

(1) A requirement that public notice be given and a hearing held before issuance of the bonds;

(2) A restriction on the costs of issuance (e.g., bond attorney and underwriter fees) that may be financed with bond proceeds to an amount not exceeding two percent of the bond issue;

(3) A minimum rehabilitation requirement for existing property that is acquired with State and local government bond proceeds;

(4) A limit on the amount of land that may be financed with any single bond issue; and

(5) Loss of interest deductions for private borrowers receiving bond proceeds if the bond-financed property ceases to be used in a qualifying use.

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[14] A portion of the private business use financed with certain larger (i.e., over $150 million) governmental bond issues also is subject to these volume limitations.

[15] Bonds for privately owned high-speed intercity rail facilities must receive a State volume limit allocation equal to 25 percent of the bond amount.

[16] As noted above, qualified veterans' mortgage bonds are subject to separate volume limits based on historical State issuance as part of the 1984-enacted phase-out of that program.

G. Contributions of Qualified Conservation Interests

Charitable contributions generally

Subject to certain limitations, a deduction is permitted for contributions of property to charitable organizations, to the United States, or to a State or local government. The amount of deduction generally equals the fair market value of the property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (secs. 170, 2055, and 2522, respectively).

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally does not give rise to a charitable deduction (for income, estate, or gift tax purposes) unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions to the partial interest rule are provided for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

Qualified conservation interests

Qualified conservation interests are real property interests donated in perpetuity for any of the following conservation purposes:

(1) The preservation of land areas for outdoor recreation by, or for the education of, the general public;

(2) The protection of a natural habitat of fish, wildlife, plants, or a similar ecosystem;

(3) The preservation of open space (including farmland and forest land) but only if such preservation either (a) is for the scenic enjoyment of the general public, or is pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and (b) will yield a significant public benefit; or

(4) The preservation of an historically important land area or a certified historic structure (sec. 170(h)).

Deductible conservation interests may take any of three forms. First, the value of a remainder interest is deductible. Second, the value of a restriction (e.g., an easement) granted in perpetuity on the use of the property is deductible. Finally, the contribution of the donee's entire interest in a property is deductible, except that the donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals.

H. Estate Tax Preferences for Farms and Small Businesses

Special use valuation

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at their current use value, rather than full fair market value, provided that the gross estate may not be reduced more than $750,000 (sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[17] (4) the real property qualifying for current use valuation must pass to a qualified heir;[18] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (sec. 2032A (a) and (b)).[19]

If, within 10 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for

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[17] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[18] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[19] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained from the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

Deferred payment of estate tax

The estate tax is imposed on transfers at death and the tax generally is due 9 months after the date of death.[20] The Commissioner of Internal Revenue has the discretion to grant an extension to pay estate tax upon a showing of reasonable cause for a period not exceeding 10 years (sec. 6161(a)).

An executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period (sec. 6166). To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. If an election is made, the estate pays only interest for the first four years, followed by up to ten annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short term rate plus three percentage points). Under section 6601(j), however, a special four-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business (i.e., the amount of estate tax on the first $1,000,000 less the amount of any allowable unified credit).

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[20] The Commissioner of Internal Revenue may grant an extension for a period not to exceed six months (sec. 6081).

I. Foreign Investment in U.S. Real Property

In general

Nonresident alien individuals and foreign corporations (referred to herein collectively as "foreign persons") are subject to U.S. tax at a flat rate of 30 percent (or a lower rate pursuant to an applicable tax treaty) on certain types of passive income (but generally not capital gains) derived from U.S. sources. Foreign persons are subject to U.S. tax at the regular graduated rates applicable to U.S. persons on income derived from a U.S. trade or business.

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax upon the eventual disposition of such property.

Imposition of tax

Section 897(a) provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a trade or business within the United States during the taxable year. Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons.

In the case of nonresident alien individuals, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains (sec. 897(a)(2)(A)). Losses of nonresident alien individuals are taken into account under the FIRPTA provisions only to the extent that such losses would be taken into account under Code section 165(c), which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses (sec. 897(b)).

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions (sec. 897(i)). This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under the FIRPTA provisions will be taxable even if such taxation would be contrary to a treaty. This election to be

treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions.

Definition of U.S. real property interest

Under the FIRPTA provisions, U.S. tax is imposed on gains from the disposition of an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. The term "interest in real property" includes, with respect to both land and improvements thereon, fee ownership and co-ownership, leaseholds, options to acquire, and options to acquire leaseholds (sec. 897(c)(6)(A)). Moreover, the term includes partial interests in real property, such as life estates, remainders, and reversions. In addition, the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.

Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). This general rule does not apply to investments in a publicly-traded USRPHC. Under a special rule, USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year period described above, held more than 5 percent of that class of stock (sec. 897(c)(3)). Rules similar to this special rule apply to treat an interest in a publicly-traded partnership as a U.S. real property interest.

A corporation is a USRPHC if the fair market value of such corporation's U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (i) its U.S. real property interests, (ii) its interests in foreign real property, plus (iii) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)). For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate or trust (sec. 897(c)(4)(B)). Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic (sec. 897(c)(5)).

Special rules applicable to certain transactions

Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under the FIRPTA provisions to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity (sec. 897(g)).

As a general rule, nonrecognition provisions apply under the FIRPTA provisions only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (sec. 897(e)). This rule is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code. Specific rules apply to require gain recognition in certain cases. In this regard, foreign corporations are required in certain circumstances to recognize gain upon the distribution (including a distribution in liquidation or redemption) to their shareholders of appreciated U.S. real property interests (sec. 897(d)(1)). Moreover, gain generally is recognized by a foreign person under the FIRPTA provisions on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital.

Withholding on dispositions by foreign persons of U.S. real property interests

The Code generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). The withholding obligation generally is imposed on the transferee; however, in certain limited circumstances, an agent of the transferor or transferee is required to withhold. Any tax imposed on a foreign person under the FIRPTA provisions in excess of the amount withheld remains the liability of the foreign person.

The amount required to be withheld on the sale by a foreign person of a U.S. real property interest generally is 10 percent of the amount realized on the transaction (i.e., the gross sales price) (sec. 1445(a)). However, a certificate for reduced withholding may be issued by the IRS such that the amount required to be withheld will not exceed the transferor's maximum tax liability (sec. 1445(c)(1)).

There are several exemptions from the obligation to withhold on a disposition of a U.S. real property interest. First, withholding by the transferee generally is not required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, that the transferor is not a foreign person and providing the transferor's taxpayer identification number (sec. 1445(b)(2)). Second, withholding is not required on the disposition of an interest in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not a USRPHC and has not been a USRPHC during the five-year period ending on the date of disposition (sec. 1445(b)(3)). Third, withholding may be reduced or eliminated if the transferee receives a qualifying statement issued by the IRS that the transferor is exempt from tax or either the transferor or the transferee has provided adequate security or has made other arrangements for payment of the tax (sec. 1445(b)(4)). Fourth, withholding is not required if the transferee intends to use the transferred real property as a residence, and the amount realized by the transferor on the disposition of the property is $300,000 or less (sec. 1445(b)(5)). Fifth, withholding is not required on a disposition of stock of a class that is regularly traded on an established securities market (sec. 1445(b)(6)).

Special withholding rules apply in the case of certain dispositions of U.S. real property interests by partnerships, trusts, and estates; certain distributions by foreign or domestic corporations, partnerships, trusts and estates; and certain dispositions of interests in partnerships, trusts, and estates.

Reporting requirements and penalties for noncompliance

Section 6039C of the Code authorizes the IRS to require reporting by foreign persons holding direct investments in U.S. real property interests, and imposes penalties for failure to file any required reports. However, to date no such requirements have been imposed.